

**AUDIT MANUAL**  
**Chapter 9**

**Grocers**

*Sales and Use Tax*



Department of Business Taxes  
*California State Board of Equalization*



## CHAPTER 9

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## CHAPTER 9

### GROCERS

0900.00

### INTRODUCTION

0901.00

#### GENERAL

0901.05

For purposes of this chapter, a grocer is a retailer whose principal business is the sale of foodstuffs and related items. The term includes separate grocery departments in department stores, but excludes any retail establishment that handles groceries as a sideline. Also excluded are delicatessens and country or general merchandise stores.

A problem often arises in audits of liquor stores with a substantial volume of sales of merchandise normally sold in grocery stores. Whether these qualify as grocery stores will depend on the fundamental nature of the business. Generally, in order to fall within the definition of a grocery store, at least 50% of the total sales should be comprised of exempt food products and taxable grocery sales.

#### AUDIT PROCEDURES

0901.10

Due to the heterogeneous nature of the retail grocery industry, auditing procedures must be flexible enough to meet every condition encountered. Procedures appropriate for use in auditing the corner grocery may not be the same as those used in auditing chain store operations.

The instructions and suggestions which follow are not intended to be rigid and inflexible, but are designed as guide lines which can be followed to help simplify and attain more uniformity in grocery store auditing. Reasons for major deviations from procedures outlined herein should be fully explained in audit working papers.

Many of the provisions of Regulation 1602.5 have major significance only for the larger grocers. In applying the regulation to audit situations, primary consideration should be given to materiality. The taxpayer should always be advised of correct reporting procedures, whether the purchase-ratio, markup or any other method of reporting is used. If adjustments are not made for factors deemed not to be significant, the taxpayer should be so informed and appropriate audit comments should be made.

The audit method should conform to the taxpayer's method of reporting insofar as it is practical and possible. The auditor is justified in using an audit method different from the method of reporting used by the taxpayer if:

- a) The taxpayer's records are fragmentary and incomplete, making proper verification impossible.
- b) Use of the taxpayer's method produces an unrealistic or illogical result.

If the taxpayer has used more than one reporting method during the audit period, the auditor should use the method used by the taxpayer for each reporting period unless it can be shown that total sales are not properly recorded.

## AUDIT MANUAL

### TOTAL SALES

0902.00

#### GENERAL

0902.05

Chapter 4 of the Audit Manual outlines various procedures for verifying total sales in general. Much of this material is applicable to audits of grocers.

#### VERIFICATION OF TOTAL SALES

0902.10

The extent of verification of total sales will depend to some extent on the reporting method used by the taxpayer and the audit method used by the auditor.

#### VERIFICATION OF TOTAL SALES — PURCHASE-RATIO-METHOD

0902.15

When the purchase ratio method is used to verify the sales of food products, it is essential that total sales first be established as being accurate. *If total sales are impeached the mark-up-method should be used for audit purposes.*

#### VERIFICATION OF TOTAL SALES — MARK-UP METHOD

0902.20

Where it is necessary to mark up purchases to determine taxable sales, the verification of total sales is not essential. In some instances, however, it may be desirable to verify total sales as further support for recommended determinations or refunds.

#### USING INCOME TAX RETURNS IN VERIFICATION

0902.25

Income tax returns may be of value in the verification process. However, they cannot be expected to be more accurate than the records from which they were prepared. They are sometimes useful as supplemental verification of purchases, cost of sales or sales and are a possible source of information regarding acquisition and disposition of capital assets.

Differences between reported sales per income tax returns and sales tax returns do not necessarily mean the latter have been prepared inaccurately. The procedures set forth in Chapter 4 of the Audit Manual should be followed where these differences are present.

#### BARTER SYSTEM

0902.30

It is not uncommon for grocers operating in rural areas to purchase farm products from their customers. In many instances the farmer trades his products for staple groceries and supplies. The auditor should verify that the value of the merchandise so traded is included in sales and purchases.

#### SALES OF CAPITAL ASSETS

0902.35

Taxable sales of equipment generally can be verified by examination of general ledger accounts, cash receipts records or income tax returns.

Generally, tax applies to the sales of tangible personal property held or used in the course of an activity requiring the holding of a seller's permit. Sales of fixtures and equipment used in a grocery store are subject to tax regardless of the fact that certain fixtures and equipment were used exclusively in selling food products. For example, a sale of fixtures and equipment used exclusively in the meat department operated under the same ownership as the grocery store in which it is located is subject to tax because the property was used in a unitary business requiring a seller's permit. (See Regulation 1595.)

Sales of fixtures and equipment used exclusively in a business for which a seller's permit is not required, and not as part of a unitary business requiring a permit, may be exempt as occasional sales. For example, the sale of a refrigeration unit used in a meat market making no sales of dog food, bones, or any taxable items would be exempt unless such sales qualify the taxpayer as a retailer of equipment.

## **GROCERS**

### **COUPONS REDEEMED BY LOCAL RETAILERS**

**0902.40**

Grocers often redeem coupons for manufacturer's products. The manufacturer may handle the distribution of the coupons or may authorize the grocer to publish a coupon in a newspaper or handbill advertisement. The coupon offers the bearer a specified amount off the regular price of the manufacturer's product, and the manufacturer agrees to pay the retailer for each coupon redeemed plus an amount for handling.

Amounts paid by a manufacturer to a retailer for coupons redeemed by the retailer, exclusive of amounts paid for handling, constitute gross receipts of the retailer. If the amount paid by the manufacturer, exclusive of handling, is less than the face value of the coupon, only the amount paid is includable in the retailer's gross receipts since there is no consideration for the difference.

Many stores use coupon redemption centers that make a charge for their services. If the service charge made by the coupon redemption center is greater than the handling charge permitted by the manufacturer, the excess charge may not be deducted from gross receipts. Regardless of the reporting method used by the grocer, the auditor should verify that amounts received or accrued by the grocer for the redemption of coupons are treated as gross receipts from the sale of the product and not as a reduction of purchases.

### **FEDERAL FOOD STAMPS**

**0902.45**

Sales made by retailers in exchange for food stamps are not sales to the United States Government and accordingly are not exempt from the California sales and use tax. Basically, the food stamp is, for all intents and purposes, nothing more than a non-negotiable check much like a social security check.

Federal food stamps may be used for the purchase of food products only. There are some items for which food stamps may be used, however, which are taxable; e.g., soft drinks, food coloring, etc.

The proper measure of the tax with regard to these items is the face value of the stamps. The fact that the stamps are purchased at a discount by the recipients is immaterial.

## **AUDIT MANUAL**

### **PURCHASES SUBJECT TO USE TAX**

**0903.00**

#### **TYPES**

**0903.05**

The average grocer's liability for purchases subject to use tax is generally limited to

- a) Merchandise withdrawn from stock and converted to own use.
- b) Capital and expense items purchased under a resale certificate or from an out-of-state retailer.

#### **MERCHANDISE WITHDRAWN FROM STOCK**

**0903.10**

Grocers often do not maintain records of merchandise withdrawn from stock; where that situation exists the auditor should reach an agreement with the taxpayer as to a reasonable estimate.

Unless a grocer maintains separate records of both taxable and nontaxable items withdrawn from stock, the taxable amount thereof may be considered to be in the same ratio to total withdrawals that taxable purchases are to total purchases.

#### **SELF-CONSUMED MERCHANDISE IN GROCERY AUDITS**

**0903.15**

The over-all markup percentage is a pertinent factor in verifying total sales of a grocer. It may be necessary for the auditor to make an adjustment for stock withdrawals before computing the markup. The manner in which a taxpayer reports these withdrawals will in some instances materially affect computed taxable sales.

#### **PROCEDURE WHERE WITHDRAWALS OF MERCHANDISE HAVE NOT BEEN REPORTED**

**0903.20**

##### **A. WHERE PURCHASE RATIO METHOD IS USED**

Apply the taxable purchase ratio to total amount of merchandise withdrawn by the taxpayer. The amount so computed will be set up on Schedule 2. When using this procedure, neither purchases nor total sales need be disturbed.

##### **B. WHERE THE PURCHASE MARKUP METHOD IS USED**

Estimated taxable withdrawals of merchandise should be set up at cost on Schedule 2. The amount so set up should then be deducted from taxable purchases and a weighted markup applied to the remainder of taxable purchases.

#### **PROCEDURE WHERE MERCHANDISE WITHDRAWALS HAVE BEEN REPORTED**

**0903.25**

##### **A. WHERE INCLUDED ON LINE 1**

Where both the taxable and nontaxable items have been included at cost, no adjustment need be made when the purchase-ratio-method is used. If taxable items only have been included, they should be deleted from Line 1 before applying the purchase ratio. The amount deleted should then be set up on Schedule 2.

##### **B. WHERE INCLUDED ON LINE 2**

When the cost of taxable items only has been reported, no further adjustment need be made. If, however, nontaxable items have been included, or the merchandise has been priced at retail, a credit should be allowed.

#### **CAPITAL EXPENDITURES**

**0903.30**

General ledger accounts, purchase invoices, and depreciation schedules should be examined to determine if any capital equipment has been acquired ex-tax during the audit period. Observation of the premises may be helpful in determining any acquisitions of new equipment.

#### **PURCHASES SUBJECT TO USE TAX**

**0903.35**

The average grocer makes few direct purchases subject to use tax. He may, however, purchase expense items ex-tax from his regular wholesale sources. When auditing grocers who are located near cities in bordering states, the auditor should be on the alert for purchases of supplies and equipment from out-of-state retailers.



## **GROCERS**

### **AUDIT OF CLAIMED DEDUCTIONS**

**0904.00**

#### **GENERAL**

**0904.05**

Chapter 4 of the Audit Manual outlines general procedures to be used in verifying deductions. Only those deductions peculiar to grocery stores will be discussed in this chapter.

#### **SALES FOR RESALE**

**0904.10**

After having verified the accuracy of sales for resale, the cost of resales as well as the total sales for resale should be eliminated from purchases and total sales, respectively, for purchase-ratio purposes. This procedure is necessary as seldom, if ever, do sales for resale have the same taxable ratio as do sales to consumers.

#### **SALES OF FOOD PRODUCTS FOR HUMAN CONSUMPTION**

**0904.15**

Grocers may use any method they choose to compute the amount of sales of food products for human consumption claimed on their sales tax returns. They must, of course, maintain adequate records to support the amount so claimed. Audit procedures for verifying this deduction are explained in subsequent sections.

#### **TRADING STAMPS**

**0904.20**

Many grocers issue trading stamps in connection with sales made to customers. The cost of the stamps purchased by the grocer constitute cash discounts. Generally, grocers do not issue these stamps in connection with sales of distilled spirits, cigarettes, beer, wine, milk, or publications. (Refer to Chapter 4 regarding appropriate reimbursement of tax.)

The deduction for trading stamps should be based on the ratio that taxable sales for which stamps are issued bears to total sales for which stamps are issued. This ratio is then applied to total stamp purchases to determine the taxable portion. The ratio may be computed on a test basis, i.e., the ratio obtained after adjusting taxable and total sales for a representative period, by the amount of taxable and total sales respectively, on which stamps are not given. This procedure should be followed in all cases where the adjustments would affect the ratio significantly and the deduction is of material consequence.

In some cases this procedure may not be necessary. In the case of many small stores where the amount of stamps involved is minor, the deduction may be based on the unadjusted taxable sales ratio. This short-cut procedure should be used only when the result of adjusting for sales on which stamps are not given, would be insignificant.

Often trading stamp companies rebate part of the cost of the stamps above a certain percentage of sales. Miscellaneous sources of income should be examined for such rebates.

#### **BOTTLE DEPOSITS AND OVER-RINGS**

**0904.25**

Bottle deposits are not part of gross receipts from sales. If such deposits are segregated, they will be excluded from total sales. In this case care should be exercised to insure that refunds of such deposits are not netted from total sales. If it is established that bottle deposits are included in total sales, but that refunds of such deposits have been treated as cash payouts and not netted from total sales, the deduction claimed for this item should be allowed without further verification unless it is out of proportion to the volume of sales. When deposits are not segregated but are included in total sales, and deposit refunds are netted from total sales, it will be presumed in the absence of evidence to the contrary, that the total deposits received are equal to the deposits refunded.

Deductions claimed for over-rings, if reasonable, may be allowed without further verification. If this deduction appears excessive, verification should then be made by test checking the documents supporting the over-rings for several scattered days.

## AUDIT MANUAL

### REIMBURSEMENT FOR SALES TAX INCLUDED IN TOTAL SALES

**0904.30**

The general procedure for verifying deduction for sales tax included in total sales is outlined in Chapter 4 of the Audit Manual. The following example illustrates the "More Accurate Method".

|  |          |
|--|----------|
| a) Audited taxable grocery purchases .....   | \$ 4,000 |
| b) Audited sales tax differential (6% of Item a) .....   | 240      |
| c) Audited purchases .....   | 22,000   |
| d) Audited nongrocery taxable purchases .....  | 2,000    |
| e) Grocery purchases (item c minus item d) .....   | 20,000   |
| f) Adjusted grocery purchases (Item e plus Item b) .....   | 20,240   |
| g) Food purchases (Item e minus Item a) .....  | 16,000   |
| h) Food ratio (Item g divided by Item f) .....   | 79.0514% |
| i) Total sales per audit .....   | 28,400   |
| j) Nongrocery taxable sales per books, including sales tax<br>(if sales are not recorded separately, mark-up Item d) ..... | 3,180    |
| k) Grocery sales (Item i minus Item j) .....   | 25,220   |
| l) Food sales (Item h times Item k) .....  | 19,937   |
| m) Taxable sales (Item i minus Item l) .....   | 8,463    |
| n) Sales tax included (6/106 of Item m) .....  | 479      |
| o) Measure of tax (Item m minus Item n) .....  | 7,984    |
| p) Sales tax payable (6% of Item o) .....  | 479      |

All amounts and the tax rate are for illustration only. The actual amounts and applicable tax rate must be determined in each particular case.

An example of the "More Accurate Method" of computing sales tax included when nongrocery taxable sales are not a factor follows:

#### Facts:

|   |                       |
|---|-----------------------|
| Total Grocery Sales including Sales Tax ..... | \$1,250,000           |
| Purchases: Food Products                      | \$ 750,000      75%   |
| Grocery Taxable                               | <u>250,000</u> 25%    |
|   | \$1,000,000      100% |

#### Computation:

Exempt Food Products Ratio:

$$\frac{750,000}{750,000 + 250,000 + 15,000 (6\% \text{ of } 250,000)} = 73.8916\%$$

|  |                |
|--|----------------|
| Total Sales Including Tax .....                  | \$1,250,000    |
| Less Food Products (73.8916% of 1,250,000) ..... | <u>923,645</u> |
| Taxable Sales Including Tax .....                | 326,355        |
| Sales Tax Included (6/106 of 326,355) .....      | <u>18,473</u>  |
| Taxable Sales .....                              | \$307,882      |

## **GROCERS**

### **MEAT SCRAPS SOLD AS BY-PRODUCTS**

**0904.35**

Meat scraps sold to rendering plants should be treated as sales for resale. These sales should be excluded from total grocery sales for purchase-ratio purposes. Since these are sales of a by-product, no adjustment should be made to the cost of meat purchases.

### **NEWSPAPERS AND PERIODICAL EXEMPTIONS**

**0904.40**

Newspapers and periodicals which are regularly issued at average intervals not exceeding three months are exempt from tax. The deduction may be computed by adding 25% to the purchase price of such items in accordance with Regulation 1590, Newspapers and Periodicals.

Many grocers include sales and purchases of exempt publications in the purchase-ratio computation. Unless the overall results would be significantly affected by exclusion, the same procedure may generally be used for audit purposes. Books and other taxable publications should be segregated and treated as nongrocery taxable items.

**GROCERS' REPORTING METHODS****0905.00**

Grocers generally use one of the following methods of reporting taxable sales:

- a) Extending taxable merchandise to retail price. (See Section **0906.00**)
- b) Retail inventory method. (See Section **0907.00**)
- c) Separate key on cash register. (See Section **0908.00**)
- d) Purchase-ratio method. (See Section **0909.00**)
- e) Modified purchase-ratio method. (See Section **0910.00**)
- f) Markup of taxable merchandise. (See Section **0911.00**)
- g) Estimating.
- h) Electronic scanning systems. (See Section **0915.00**)
- i) Two or more of the above methods.

**GROCERS**

**EXTENDING TAXABLE MERCHANDISE TO RETAIL PRICE      0906.00**

This reporting method contemplates that the taxpayer will report tax based on the retail selling price of all taxable purchases during a reporting period rather than on actual taxable sales made during the period.

Verification procedure should cover

- a) Accuracy of total purchases.
- b) Accuracy of purchase segregation.
- c) Accuracy of extensions.
- d) Accuracy of adjustments for inventory fluctuations.
- e) Accuracy of adjustments for markdowns, markons, quantity sales and case sales.
- f) Accuracy of adjustment for shrinkage. (See Section **0912.00**)

**RETAIL INVENTORY METHOD**

**0907.00**

Under this method (see Regulation 1602.5) all purchases are immediately priced at retail and all control records reflect the retail values. As a rule, its use by grocers is restricted to the larger chain organizations.

| Verification procedure to be used is the same as in Section [0906.00](#)

## GROCERS

### WHEN SEPARATE KEY ON CASH REGISTER IS USED

0908.00

When the taxpayer uses this method, the following verification is necessary:

- a) Verification of accuracy of recorded sales by tracing cash register tape totals to sales register for several representative periods.
- b) Verification of proper sales segregation on cash register tapes by testing a representative period using the markup method.

## PURCHASE-RATIO METHOD

0909.00

## GENERAL

0909.05

If the taxpayer is reporting by use of the purchase-ratio method, the purchase-ratio method should be used for audit purposes unless it is determined that not all sales are recorded. In such instances, the markup method should generally be used.

The validity of the purchase-ratio method is based on the premise that the over-all markup on food products is the same as on taxable merchandise. Authorization for the use of this method is contained in Regulation 1602.5. Two basic methods used in reporting sales of exempt food products are:

- a) The “Simple Method”

$$\frac{\text{Exempt Food Purchases}}{\text{Exempt Food Purchases} + \text{Taxable Grocery Purchases}} \times \text{Taxable Grocery Sales (Tax Included)}$$

Use of this method does not allow a tax included deduction.

- b) The “More Accurate Method”

$$\frac{\text{Exempt Food Purchases}}{\text{Exempt Food Purchases} + \text{Taxable Grocery Purchases} + 6\% * \text{Taxable Grocery Purchases}} \times \text{Taxable Grocery Sales (Tax Included)}$$

\* Use applicable tax rate.

This method allows a tax included deduction. (See Section 0904.30).

The “Simple Method” is most often used by small grocers who would benefit only slightly by the additional calculations required by the “More Accurate Method”. *If use of the “More Accurate Method” would result in a substantial difference, if tax included has been claimed, or if other revisions are required, the taxpayer should be given the benefit of the use of this method.*

Sections 0909.10 through 0909.50 describe the items to be included and excluded from the specific categories in the formula for the purchase-ratio method. Where concessionaire sales and purchases are included in the records, they should be eliminated before the computation of the food product percentage is made.

An example of the application of the purchase-ratio method is shown in Exhibits 1 through 4 following the text of this chapter.

## EXEMPT FOOD PURCHASES

0909.10

This classification includes purchases of all items meeting the definition of food products for human consumption as defined in Section 6359 and Regulation 1602. Purchases for all grocery departments operated by the taxpayer such as meat, fruit, produce, delicatessen (except ingredients for hot prepared food or food sold for immediate consumption at facilities provided by the grocer), and bakery should be included.

Care should be taken to exclude from exempt food purchases all purchases of operating supplies, paper bags, and expense items since these are often billed along with groceries by the larger wholesale grocers.

## TAXABLE GROCERY PURCHASES

0909.15

This classification includes purchases of all taxable items other than the type of items classified as “nongrocery taxable” in Regulation 1602.5 and Business Taxes General Bulletin 69–7. It does not include purchases of gasoline, feed for farm animals, fertilizers, or purchases of ingredients for products sold in snack bars, restaurants, or as hot prepared food products, or sold for immediate consumption at facilities provided by the grocer (see Section 0909.45)



## GROCERS

### SELF-PERFORMED COSTS

**0909.20**

Exempt food purchases and taxable grocery purchases do not include the cost of processing, manufacturing, warehousing, transportation and other costs, if these operations are self-performed. Some examples of such costs are; meat cutting and wrapping, produce preparation, meat plant operation, milk plant operation, operating bakery department, preparation of cold salads in a delicatessen department, etc.

When the purchase-ratio method is used for reporting purposes, amounts subject to the ratio include only the cost of merchandise purchased from others, and excludes any self-performed additional costs.

If a grocer includes self-performed labor or overhead costs in the purchase-ratio method, he is using a modified purchase-ratio method. Grocers using a modified method must demonstrate that the method does not result in an overstatement of the food products deduction (see Section **0910.00**).

### TOTAL GROCERY SALES

**0909.25**

This classification includes sales of all grocery departments operated by the taxpayer including meat, fruit, produce, delicatessen (except hot prepared food or food sold for immediate consumption at facilities operated by the grocer), beverage (except distilled spirits), and bakery departments. Sales tax reimbursement applicable to grocery department sales, amounts received or accrued from manufacturers or others for coupons (excluding handling allowances) redeemed by customers, and the face value of federal food stamps should also be included in grocery sales for purchase-ratio purposes. The following receipts should be excluded for ratio purposes:

- a) Selling price (including tax) of nongrocery taxable items that were eliminated from taxable grocery purchases.
- b) Sales not made in the regular course of business such as sales of equipment.
- c) Sales of meat scraps to rendering plants (see Section **0904.35**).
- d) Sales of gasoline, farm seeds, fertilizers, snack bar or restaurant operations.
- e) Deposits (see Section **0904.25**).
- f) Sales of newspapers and periodicals (see Section **0904.40**).

### BEVERAGE DEPARTMENT SALES

**0909.30**

All beverage department sales and purchases, except distilled spirits and other nongrocery taxables, should be included in the formula calculations.

### VERIFICATION OF SEGREGATION

**0909.35**

The taxpayer's purchase segregation should be verified for whatever test period or periods is deemed appropriate. Care should be taken to include both cash and check purchases. Purchases from vendors known to deal exclusively in food products need not be examined.

Certain vendors, whose sales are apparently limited to food products, however, do sell some taxable items:

- a) Some large meat packing firms sell dog food and soap.
- b) Some dairy product firms sell taxable carbonated beverages.
- c) Fruit and vegetable wholesalers may sell flowers, potted plants, etc.

Some large wholesalers identify taxable items and show taxable totals on their invoices. While the totals of taxable purchases as shown on these invoices are generally accurate, individual items should be scanned on some invoices to verify that taxable items are correctly coded. The following items are often purchased and invoiced to grocers with regular merchandise and should be excluded from all calculations:

- a) Paper bags, wrapping paper, and other container material.
- b) Trading stamps.
- c) Health insurance premiums.
- d) Operating supplies.

The following discounts constitute a reduction in the cost of merchandise for purchase ratio purposes:

- a) Cash discounts.
- b) Volume rebates or quantity discounts.
- c) Promotional allowances.

If discounts of this type are significant, exempt food and taxable grocery costs should be reduced as appropriate when the purchase-ratio method is used. Since these discounts can apply to exempt food, taxable grocery, and nongrocery taxable items, a segregation test of the discounts may have to be made. The definition of these terms follows:

As used herein, the term “cash discount” means a reduction from invoice price allowed the grocer for prompt payment.

As used herein, the term “volume rebate or quantity discount” means an allowance or reduction of the price for volume purchases based on the number of units purchased or sold. Such rebates or discounts normally are obtained without any specific contractual obligation upon the part of the grocer to advertise or otherwise promote sales of the products purchased. The term does not include patronage dividends distributed to members by nonprofit cooperatives pursuant to Section 12805 of the Corporations Code, or rebates which constitute a distribution of profits to members or stockholders.

As used herein, the term “promotional allowance” means an allowance in the nature of a reduction of the price to the grocer, based on the number of units sold or purchased during a promotional period. The allowance is directly related to units sold or purchased although some additional promotional expense may be incurred by the grocer. Normally, the grocer would feature the product in his advertising, although he may or may not be contractually obligated to do so. The retail price of the product may or may not be lowered during a promotional period. The term does not include display or other merchandising plan allowances or payments which are based on agreements to provide shelf space for a price not related to volume of purchases, or cooperative advertising allowances which are based on a national line rate for advertising and are not directly related to volume of purchases and sales. Cooperative advertising allowances are intended to reimburse a grocer for a portion of his advertising costs for a particular product or products.

## **NONGROCERY TAXABLE ITEMS**

**0909.45**

Regulation 1602.5 requires a grocer using the purchase ratio method of reporting to make a separate accounting for taxable merchandise not regularly sold in a grocery store. Purchases of such items should be segregated from grocery department purchases in the taxpayer’s records. Where this is done, verification can be performed in conjunction with testing of food products distribution. See Regulation 1602.5 and Business Taxes General Bulletin 69–7 for listings of representative nongrocery taxable items.

In some cases, grocers estimate nongrocery taxable purchases. Unless the auditor is completely satisfied that it is unwarranted, he should list these purchases for a test period. This should also be done, of course, in those cases where nongrocery taxable items have been completely ignored, unless they are insignificant (see Section **0909.15**).

When a grocer uses the purchase-ratio method for reporting purposes, and sales of nongrocery taxable (NGT) items are computed by the markup method, he usually ignores NGT inventory adjustments.

*If the audit discloses a material fluctuation in beginning and/or ending inventories of NGT items, appropriate adjustments should be made.* This situation may arise in new stores, close-outs, or when a NGT inventory is expanded. For example, in a new business, if the beginning inventory was recorded in purchases, an adjustment for the ending inventory must be made to avoid overstating the cost of sales.

The details of the adjustment should be clearly explained in the audit working papers for future audit reference.

The facts concerning the handling of inventories can most easily be determined during the first audit of a taxpayer.

If applicable, adjustments for shrinkage should also be made (see Section **0912.00**).

## **GROCERS**

### **NONGROCERY TAXABLE MARKUP**

**0909.50**

Markup calculations, whether made to establish selling price or to confirm adequacy of markup used by the taxpayer should conform to the provisions of Chapter 4. Sales tax should be added to the selling prices in the shelf test or added to the computed sales.

### **SHORT-CUT PROCEDURE**

**0909.55**

Where it is found that there have been no errors of a kind requiring quarterly recalculations of sales of food products, the accuracy of taxpayer's computations may be verified by:

- a) Computing a single food products percentage for the entire audit period, or for as long a period as is practicable. After application of this percentage to total sales, the deduction should not vary significantly from reported amounts. However, wide fluctuations in quarterly food percentages could distort the results and this procedure should not be used under such circumstances.
- b) Visual inspection for unusual variations in food percentages accompanied by a test check of the accuracy of the taxpayer's calculations for several periods.

**MODIFIED PURCHASE-RATIO METHOD**

**0910.00**

**GENERAL**

**0910.05**

Any grocer who does not follow the purchase-ratio procedure as outlined in Regulation 1602.5, but reports on a purchase ratio basis of some type is using a modified version of the purchase-ratio method. For example, grocers who include self-performed processing, manufacturing, warehousing or transportation costs in the purchase-ratio formula are using a modified version. Any grocer using such a modified version must establish that his modified version does not result in an overstatement of his food products exemption. However, if a small grocer is using a modified version of the formula, the significance of the potential error must be considered, since it may be immaterial.

**GROCERS MUST SUBSTANTIATE PROCEDURE**

**0910.10**

As provided in Regulation 1602.5, a grocer may demonstrate the adequacy of his modified method by extending taxable purchases, adjusted for inventories, to retail for a representative period or by computing taxable sales by marking up taxable purchases, adjusted for inventories, for a representative period.

**BOARD REVIEW OF SPECIFIC PROCEDURE**

**0910.15**

Grocers contemplating use of a modified purchase-ratio reporting method are urged to submit the proposed method to the Board for review and approval prior to use (see [Section 0914.00](#)).

## **GROCERS**

### **MARKUP OF TAXABLE MERCHANDISE**

**0911.00**

#### **GENERAL**

**0911.05**

If the taxpayer is reporting by use of the markup method, the markup method should be used for audit purposes. The purchase-ratio method may be used for testing purposes, however, any recommendation for assessment or refund must be supported by the markup method.

When the markup method is used for audit purposes, the guidelines on markup procedures outlined in Chapter 4 should be followed. Effect should be given to markons, markdowns, shrinkage, and inventory fluctuations. The audit procedures should also be consistent with the “cost plus markup method” guidelines set forth in Regulation 1602.5 and Section **0911.10**.

#### **GROCER TO USE SPECIFIC PROCEDURE**

**0911.10**

Regulation 1602.5 directs grocers who elect to use the cost plus markup method of reporting to follow certain procedures in determining and using taxable markup factor percentages to compute taxable sales. Briefly, the grocer must determine markup factor percentages by commodity groupings by making a shelf test of purchases covering a minimum purchasing cycle of one month within a three-year period. The markup factor percentages are then applied to the cost of sales of the respective commodity groupings for the reporting period to compute taxable sales for the reporting period.

As an alternate procedure, the overall average taxable markup factor percentage may be determined and applied to the overall cost of taxable sales for the reporting period as explained in Regulation 1602.5. An example of the alternate procedure and the type of commodity groupings contemplated is illustrated by **Exhibits 5** through **7**.

Grocers should be urged to follow these procedures when reporting by the markup method.

#### **BOARD REVIEW OF SPECIFIC PROCEDURE**

**0911.15**

Grocers contemplating use of the cost plus markup method of reporting are urged to submit a general outline of proposed markup procedures to the Board for review and approval prior to use of such procedures (see Section **0914.00**).

**SHRINKAGE****0912.00****GENERAL****0912.05**

The term “shrinkage” means unaccounted for losses due to spoilage, breakage, pilferage, etc. Grocers who incur such losses may, for reporting purposes, adjust for such losses in one of the following ways:

- a) Compute a loss adjustment of up to 1 percent of the cost of all their *taxable* merchandise when either the retail inventory or markup method is used for reporting purposes.
- b) Compute a loss adjustment of up to 3 percent of the cost of their *nongrocery* taxable merchandise only when the purchase-ratio method is used for reporting purposes and sales of nongrocery taxable items are computed by the retail extension or markup method. This adjustment is limited to an overall 1 percent of taxable purchases if some method other than the purchase-ratio method is used for reporting purposes.

Losses in excess of the above are allowable when evidence shows that a greater loss was sustained.

**EVIDENCE OF ADDITIONAL LOSSES****0912.10**

Support for additional losses may be in the form of reports of regularly employed security guards or reports of private detective agencies or similar service firms. However, the best evidence which a grocer can furnish to support additional losses would be through a test such as the following:

- a) Select a period for test purposes.
- b) Take beginning physical inventory — extend to retail.
- c) Extend all purchases for the period to retail.
- d) Take ending physical inventory — extend to retail.
- e) Adjust for markons, markdowns, quantity sales, case sales, etc.
- f) Difference between anticipated and recorded sales should represent shrinkage.

Any such test would of course have to be properly verified to insure that all elements involved, including sales recording procedures, had been properly controlled.

**AUDIT ADJUSTMENTS****0912.15**

If a grocer has not claimed shrinkage allowances or has claimed less than the allowances specified, audit adjustments for additional shrinkage should be made only after it is shown that the markup factors in use have been accurately computed and are not simply estimates. If this can be shown, or if it is necessary to recompute markup factors for audit purposes, adjustments for shrinkage, within the limitations of Regulation 1602.5, should be made. This matter should be discussed with the grocer at the time of audit.

**CREDIT FOR CLOSING INVENTORY****0913.00**

Where a retailer has made sales tax returns by marking up all taxable purchases or by marking up nongrocery taxable purchases (plus opening inventory, if any) to anticipated retail prices, a credit or refund of tax measured by the amount of the closing inventory will be in order.

Under such a situation, the provisions of Section 6908 of the Sales and Use Tax Law would preclude allowance of interest on a refund.

The following guidelines should be observed whenever the markup method has been used:

- a) A credit or refund measured by the increase in inventory is allowable, even if the taxpayer omitted the opening inventory from the markup computation.
- b) The same principle applies even if the markup method was used only for one phase of a business, such as nongrocery taxable sales. However, when such an adjustment is made with respect to nongrocery taxable sales, and the taxpayer has otherwise used the purchase ratio method, an adjustment to total grocery sales may also be necessary for ratio purposes.
- c) To avoid establishing a tax paid inventory when using the markup method for audit purposes, the markup should always be applied to cost of goods sold rather than to purchases. This procedure should be made clear in the audit working papers.  
If purchases are considered to constitute cost of goods sold because inventories are consistent, unavailable, and/or unreliable, the audit comments should so state.
- d) After an audit is made, all inventories should be left on an ex-tax basis even if it is necessary to recommend a refund to accomplish this. A comment stating that inventories were left on an ex-tax basis should be made on the back of the BOE-414-A.  
The taxpayer should be advised to use cost of goods rather than purchases, for markup purposes, to avoid establishing a tax paid inventory.
- e) When computing a tax paid inventory credit, the statute of limitations is not a factor. Inventory fluctuations all the way back to the inception of the present ownership of the business, or to the earliest date where reliable information regarding inventories, purchases, and reporting method is available, should be considered. This approach is based on the first in first out inventory principle, so that overreporting resulting from inventory accumulation is considered to have occurred in the most recent reporting period or periods.
- f) A markup reporting method applied to purchases rather than cost of goods sold, over an extended period of time, can result in distortions of tax liability if the tax rate has changed one or more times during the period. However, the significance of any such variance generally would not warrant the expenditure of time which would be required to adjust for this factor.
- g) When making adjustments of this nature, proper effect must be given to documented fire losses, burglary losses, pilferage, self-consumption, etc.
- h) The beginning inventory will be considered tax paid only if it can be shown that it was included in the amounts marked up and reported, or that separately stated tax reimbursement was paid to the retailer from whom the beginning inventory was purchased.

## AUDIT MANUAL

### BOARD APPROVAL OF SPECIFIC REPORTING PROCEDURES

0914.00

#### APPROVAL GUIDELINES

0914.05

As provided in Regulation 1602.5, grocers who are contemplating use of a *modified purchase ratio* or *cost plus markup* method of reporting are urged to notify the Board of such intentions and to submit the proposed procedures to the nearest Board office for review prior to use of such procedures. The review, approval, and agreement with the taxpayer on proposed procedures will normally be done at the district or subdistrict level subject to concurrence of the Principal Tax Auditor. Proposed procedures must be consistent with Regulation 1602.5 and the following guidelines:

- a) The Board has agreed with the California Grocers Association to review proposed reporting procedures in advance of use, when requested to do so.
- b) All requests should be honored and sufficient time should be spent to insure that proposed reporting procedures are proper. Time spent in reviewing and approving such requests should be charged to Advisory Services Code 3208, except if verification and instruction are in conjunction with audit verification, in which case, the time should be charged to Direct Field Code 3103.
- c) Information furnished to the Principal Tax Auditor on proposed reporting procedures must spell out in detail the agreement worked out with the taxpayer on procedures to be followed and the recommended period of authorization.
- d) Authorizations for use of approved procedures generally should be issued to coincide with the ending period of the next audit plus one quarter. However, letters of authorization should not be issued for periods of less than two years. Therefore, if the next anticipated audit period ends in a period less than eighteen months from the date of the request, the authorization should be granted for three years plus the period to the end of the next scheduled audit plus one quarter. For example, if the last audit was through December 1970, and a request is received in July 1973, the authorization should be for the period ending March 31, 1977. On the other hand, if the last audit was through December 1972, the authorization should be through March 31, 1976.  
The approval should be granted subject to the understanding that the procedures will be reexamined at the time of the next regularly scheduled audit and the taxpayer will be required to make current tests as deemed necessary in order to obtain a new letter of authorization.
- e) Written authorization of approved procedures will be furnished to the taxpayer by the Principal Tax Auditor only. Districts will not furnish written approval. This is to insure uniformity of practice and maintenance of a central record of all authorizations. It is therefore essential that districts furnish the Principal Tax Auditor with complete information on proposed reporting procedures.
- f) Letters of authorization will not normally be furnished for reporting procedures other than modified purchase-ratio or cost plus markup, as specifically provided for in Regulation 1602.5.



## **GROCERS ELECTRONIC SCANNING SYSTEMS**

**0915.00**

### **GENERAL**

**0915.05**

Electronic scanning systems utilize electronic scanners and central computers to automatically compile and record taxable and nontaxable sales, sales tax, and related data from scanning of products imprinted with the Universal Product Code. If a grocer contemplates use of scanning system results for sales tax reporting purposes, it is important to ensure that proper controls are maintained for monitoring and verifying the accuracy of the scanning results and tax returns. For example, the scanning programs relating to product identity, price, sales tax code, program changes and corrections, etc., must be retained for future examination by the Board's audit staff. Records which clearly show a segregation of taxable and nontaxable merchandise purchases would also provide grocers and the Board with additional data from which the scanning accuracy may be monitored or verified.

### **PURCHASE SEGREGATION MAY BE REQUIRED**

**0915.10**

Regulation 1602.5 provides that a grocer may use any method of reporting which can be supported as properly reflecting sales of exempt food products. However, it is the grocer's responsibility to establish the propriety of the amount of the claimed deduction. Therefore, if the accuracy of the claimed deduction for sales of exempt food products cannot otherwise be verified, the grocer should, in the absence of segregated purchases, be required to segregate at least a representative sample of purchases to provide a basis for verification of the claimed deduction.

### **BOARD REVIEW OF SPECIFIC PROCEDURE**

**0915.15**

Grocers contemplating use of scanning systems results for sales tax reporting purposes are urged to submit a general outline of the proposed reporting method to the Board for review and approval prior to adoption of such method for reporting purposes.

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# Computation of Food Products (Purchase-Ratio Method)

[5A] Exhibit 1

| SCHEDULE 5A PAGE              |   |  |   |               |               |                |   |
|-------------------------------|---|--|---|---------------|---------------|----------------|---|
| ACCOUNT NO. SX - AA-98-000000 |   |  |   |               |               |                |   |
| AUDITOR J.B.L.                |   |  |   |               |               |                |   |
| DATE 10-18-XX                 |   |  |   |               |               |                |   |
|                               | A | B  | C | D             | E             | F              | G |
| REFERENCE                     |   |  |   |               |               |                |   |
| 1                             |   |  |   |               |               |                |   |
| 2                             |   | Audited Taxable Grocery Purchases            |   |               | <5B>          | 897622         |   |
| 3                             |   | Sales Tax Differential @ 6%                  |   |               |               | 53857          |   |
| 4                             |   | Audited Food Purchases                       |   |               | <5B>          | <u>4292209</u> |   |
| 5                             |   |  |   |               |               |                |   |
| 6                             |   | Total Audited Grocery Purchases              |   |               |               | 5243688        |   |
| 7                             |   |  |   |               |               |                |   |
| 8                             |   | Food Products Ratio <Line 4 ÷ line 6>        |   |               |               | 81.85%         |   |
| 9                             |   |  |   |               |               |                |   |
| 10                            |   |  |   |               |               |                |   |
| 11                            |   | Audited Sales <tax included>                 |   |               | <1>           | 6821060        |   |
| 12                            |   | less Non-grocery Taxable Sales:              |   |               |               |                |   |
| 13                            |   |  |   |               | Distilled     |                |   |
| 14                            |   |  |   | N.G.T.        | Spirits       |                |   |
| 15                            |   | Audited Purchases <5B>                       |   | 286887        | 143683        |                |   |
| 16                            |   | less Shrinkage @ 3%                          |   | 8607          | 4310          |                |   |
| 17                            |   |  |   |               |               |                |   |
| 18                            |   | Adjusted Purchases                           |   | 278280        | 139373        |                |   |
| 19                            |   | Markup Factor <tax included>                 |   | 155.3%        | 134.1%        |                |   |
| 20                            |   |  |   |               |               |                |   |
| 21                            |   | Non-grocery Taxable Sales                    |   | <u>432169</u> | <u>186899</u> | <u>619068</u>  |   |
| 22                            |   |  |   |               |               |                |   |
| 23                            |   | Audited Grocery Sales                        |   |               |               | 6201992        |   |
| 24                            |   |  |   |               |               |                |   |
| 25                            |   | Audited Food Products <line 8 x line 23>     |   |               |               | 5076330        |   |
| 26                            |   | Claimed Food Products                        |   |               |               | <u>5187410</u> |   |
| 27                            |   |  |   |               |               |                |   |
| 28                            |   | Difference                                   |   |               |               | 111080         |   |
| 29                            |   |  |   |               |               |                |   |
| 30                            |   | Percentage of Difference <line 28 ÷ line 26> |   |               |               | <u>21.4%</u>   |   |
| 31                            |   |  |   |               |               | <5>            |   |
| 32                            |   |  |   |               |               |                |   |
| 33                            |   |  |   |               |               |                |   |
| 34                            |   |  |   |               |               |                |   |
| 35                            |   |  |   |               |               |                |   |
| 36                            |   |  |   |               |               |                |   |
| 37                            |   |  |   |               |               |                |   |
| 38                            |   |  |   |               |               |                |   |
| 39                            |   |  |   |               |               |                |   |
| 40                            |   |  |   |               |               |                |   |

**Application of Purchases Segregation Test**  
(Purchase-Ratio Method)

[5B] Exhibit 2

| Application of Purchase Segregation Test  |               |                 |                              |                   |         | SCHEDULE 5B                   | PAGE |
|---|---------------|-----------------|------------------------------|-------------------|---------|-------------------------------|------|
| Audit Period 7-1-xx through 6-30-xx   |               |                 |                              |                   |         | ACCOUNT NO. SX - AA-98-000000 |      |
|   |               |                 |                              |                   |         | AUDITOR J.B.L.                |      |
|   |               |                 |                              |                   |         | DATE 10-18-xx                 |      |
|   | A             | B               | C                            | D                 | E       | F                             | G    |
| Period  | Food Products | Taxable Grocery | Purchase Taxable Non Grocery | Distilled Spirits | Total   |                               |      |
| REFERENCE   |               |                 |                              |                   |         |                               |      |
| 7/1/xx - 6/30/xx  | 1662593       | 345568          | 72349                        | 43196             | 2123706 |                               |      |
| 7/1/xx - 12/31/xx   | 2008012       | 469767          | 99011                        | 58721             | 2635511 |                               |      |
| 1/1/xx - 3/31/xx  | 299541        | 72303           | 18910                        | 9038              | 399792  |                               |      |
| 4/1/xx - 6/30/xx  | 338475        | 85859           | 26306                        | 10752             | 461392  |                               |      |
| Total   | 4308621       | 973497          | 216576                       | 121707            | 5620401 |                               |      |
| <5C>  | - .292%       | - 1.35%         | 1.251%                       | .391%             |         |                               |      |
| Change  | - 16412       | - 75875         | 70311                        | 21976             | - 0 -   |                               |      |
|   | 4292209       | 897622          | 286887                       | 143683            | 5620401 |                               |      |
| To 5A   | To 5A         | To 5A           | To 5A                        | To 5A             |         |                               |      |
| <p>This schedule illustrates one method of proper application of the results of segregation test of purchases for a test period to total recorded purchases for the entire audit period. The taxpayer segregated his purchases as indicated.</p>  |               |                 |                              |                   |         |                               |      |
| <p>For Comparison Only</p>  |               |                 |                              |                   |         |                               |      |
| <p>These percentages are applied to appropriate class of recorded purchases (Line 9).</p>   |               |                 |                              |                   |         |                               |      |
| <5C>  | - .4%         | - 7.86%         | 18.24%                       | 159%              |         |                               |      |
| Change  | - 17234       | - 76517         | 39503                        | 19351             | - 34897 |                               |      |
| <p>Note that application of a percentage of error by category, rather than by relation to total purchases for the test period, results in a distortion as illustrated. This method is inaccurate because it results in a difference between audited and recorded purchases, even though only the segregation of purchases by the taxpayer is being questioned. If errors that affect total purchases are made by taxpayers, adjustments should be made by the auditor as necessary.</p> |               |                 |                              |                   |         |                               |      |

These percentages are applied to total recorded purchases figure.

"Difference" in purchases (due to method of application).

# Results of Purchases Segregation Test (Purchase-Ratio Method) [5C] Exhibit 3

| Results of Purchase Segregation Test |                                  |         |             |           |        | SCHEDULE 5C                   | PAGE  |
|--------------------------------------|----------------------------------|---------|-------------|-----------|--------|-------------------------------|---|
| January 19xx                         |                                  |         |             |           |        | ACCOUNT NO. SX - AA-98-000000 |   |
|                                      |                                  |         |             |           |        | AUDITOR J.B.L.                |   |
|                                      |                                  |         |             |           |        | DATE 10-18-xx                 |   |
|                                      | A                                | B       | C           | D         | E      | F                             | G   |
|                                      | <----- Recorded Purchases -----> |         |             |           |        |                               |   |
|                                      | Food                             | Taxable | Taxable     | Distilled | Total  |                               |   |
|                                      | Products                         | Grocery | Non Grocery | Spirits   |        |                               |   |
| REFERENCE                            |                                  |         |             |           |        |                               |   |
| 1                                    | 117288                           | 27408   | 10943       | 3915      | 159554 |                               |   |
| 2                                    |                                  |         |             |           |        |                               |   |
| 3                                    |                                  |         |             |           |        |                               |   |
| 4                                    | <5D>                             | - 466   | - 2154      | 1996      | 624    | - 0 -                         | Result of test — various errors in segregation                                  |
| 5                                    |                                  |         |             |           |        |                               |   |
| 6                                    |                                  |         |             |           |        |                               |   |
| 7                                    |                                  |         |             |           |        |                               |   |
| 8                                    |                                  |         |             |           |        |                               |   |
| 9                                    | - .292%                          | - 1.35% | 12.51%      | .391%     |        |                               | Percentages of error — based on relation to total purchases during test period. |
| 10                                   |                                  |         |             |           |        |                               |   |
| 11                                   |                                  |         |             |           |        |                               |   |
| 12                                   | <----- to 5B ----->              |         |             |           |        |                               |   |
| 13                                   |                                  |         |             |           |        |                               |   |
| 14                                   |                                  |         |             |           |        |                               |   |
| 15                                   |                                  |         |             |           |        |                               |   |
| 16                                   |                                  |         |             |           |        |                               |   |
| 17                                   |                                  |         |             |           |        |                               |   |
| 18                                   |                                  |         |             |           |        |                               |   |
| 19                                   |                                  |         |             |           |        |                               |   |
| 20                                   |                                  |         |             |           |        |                               |   |
| 21                                   |                                  |         |             |           |        |                               |   |
| 22                                   |                                  |         |             |           |        |                               |   |
| 23                                   | For Comparison Only              |         |             |           |        |                               | Percentages of error — based on relation to differences by separate category.   |
| 24                                   |                                  |         |             |           |        |                               |   |
| 25                                   |                                  |         |             |           |        |                               |   |
| 26                                   | - .4%                            | - 7.86% | 18.24%      | 159%      |        |                               |   |
| 27                                   | <----- to 5B ----->              |         |             |           |        |                               |   |
| 28                                   |                                  |         |             |           |        |                               |   |
| 29                                   |                                  |         |             |           |        |                               |   |
| 30                                   |                                  |         |             |           |        |                               |   |
| 31                                   |                                  |         |             |           |        |                               |   |
| 32                                   |                                  |         |             |           |        |                               |   |
| 33                                   |                                  |         |             |           |        |                               |   |
| 34                                   |                                  |         |             |           |        |                               |   |
| 35                                   |                                  |         |             |           |        |                               |   |
| 36                                   |                                  |         |             |           |        |                               |   |
| 37                                   |                                  |         |             |           |        |                               |   |
| 38                                   |                                  |         |             |           |        |                               |   |
| 39                                   |                                  |         |             |           |        |                               |   |
| 40                                   |                                  |         |             |           |        |                               |   |

SCHEDULE 5C PAGE

Examination of Purchases

ACCOUNT No. SX - AA-98-000000

Test Period - January 19xx

AUDITOR J.B.L.

DATE 10-18-XX

| A         | B    | C              | D              | E                | F | G                | H             | I               | J                   | K                 | L | M             | N              |
|-----------|------|----------------|----------------|------------------|---|------------------|---------------|-----------------|---------------------|-------------------|---|---------------|----------------|
| REFERENCE | Date | Vendor         | Invoice Number | Items            |   | Cost per Invoice | Food Products | Taxable Grocery | Taxable Non-Grocery | Distilled Spirits |   | Selling Price | Mark-up Factor |
| 1-17-XX   | 20   | Moore Clark    | 16589          | Kites            |   | 54.65            | -54.65        |                 |                     |                   |   | 81.60         |                |
| 25        |      | " "            | 13366          | Sundries         |   | 100.87           | -272.50       |                 |                     | 272.50            |   | 150.61        |                |
|           |      |                | 742            | D/S              |   |                  |               |                 |                     |                   |   |               |                |
| 2         |      | Hostess Prides | 20151          | Tools            |   | 154.47           | -154.47       |                 |                     | 154.47            |   | 230.34        |                |
| 30        |      | Blackwood Co.  | 471            | Grape Juice Bars |   | 12.00            | -12.00        |                 |                     |                   |   |               |                |
|           |      | Total          |                |                  |   | 6309.00          | -466.00       | -21.54          | 1996                | 624               |   | 9243          | 146.5%         |

This schedule illustrates a method of combining an analysis of recorded purchases with a markup computation for taxable nongrocery sales.

The taxpayer has used a markup of 34.1%, including tax, on distilled spirits. This has been accepted by the auditor.

This schedule might also be used for a test to delete supplies recorded as purchases.

**Computation of Taxable Sales to be Reported**  
(Cost plus Markup Method)

**Exhibit 5**

**Sample Schedule**  
**Cost Plus Markup Method**

Computation of Taxable Sales to be Reported  
Period: 3rd Quarter 1978

|  |   |                     |
|--|---|---------------------|
| Recorded Cost of Taxable Sales                   |   | \$ 403,815          |
| less: 1% Allowance for Shrinkage                 |   | <u>— 4,038</u>      |
| Adjusted Cost of Taxable Sales                   |   | <u>\$ 399,777</u>   |
| Overall taxable Markup Factor<br>(31.68% + 100%) | ① | <u>131.68%</u>      |
| Computed Taxable Sales<br>(131.68% x \$ 399,777) |   | <u>\$ 526,426</u>   |
| Sales Tax Payable<br>(6% x \$ 526,426)           | ② | <u>\$ 31,585.56</u> |

- ① Supporting markup computation illustrated herein.  
② Use applicable tax rate — tax rate of 6% used for illustration purposes.

**INSTRUCTIONAL NOTE:**

This series of schedules is illustrative of the procedure to be followed by taxpayers when making tests under the “Cost Plus Markup Method” noted in Section (b)(3)(B) of Regulation 1602.5 and as referred to in A.M. Section 0911.10.

**Computation of Overall Taxable Markup and Shelf Test on Beer (Cost plus Markup Method)**

**Exhibit 6**

**COMPUTATION OF OVERALL TAXABLE MARKUP**

Test Year: 1978

| COMMODITY  | A<br>RECORDED<br>COST OF<br>SALES | B<br>① MARKUP<br>FACTOR<br>(MU + 100%) | C<br>COMPUTED<br>TAXABLE<br>SALES<br><A x B = C> |
|--|-----------------------------------|--|--|
| Grocery Taxables   |                                   |  |  |
| Beer   | \$ 105,078                        | ③ 132.08%                              | \$ 138,787                                       |
| Wine   | 32,438                            | 147.19%                                | 47,745   |
| Carbonated beverages   | 223,815                           | 135.50%                                | 303,269  |
| Tabacco and Related products                                     | 100,781                           | 112.63%                                | 113,510  |
| Paper Products   | 131,931                           | ③ 128.78%                              | 169,901  |
| Pet Food   | 142,316                           | 123.87%                                | 176,287  |
| Soap and Detergents  | 125,712                           | 110.95%                                | 139,477  |
| Laundry Supplies   | 26,101                            | ③ 123.72%                              | 32,292   |
| Household Cleaners, Waxes and Insecticides                       | 23,087                            | 127.05%                                | 29,332   |
| Brooms, Mops, brushes, and Sponges                               | 7,522                             | 139.26%                                | 10,475   |
| Outdoor Living Needs<br>(Charcoal briquets, starter fluid, etc.) | 6,519                             | 124.40%                                | 8,110  |
| Total Grocery Taxables   | \$ 925,300                        |  | \$ 1,169,185                                     |
| Total Nongrocery Taxables  | \$ 358,626                        | ② 145.40%                              | \$ 521,442                                       |
| Total Taxables   | \$ 1,283,926                      |  | \$ 1,690,627                                     |
| Cost of Computed Taxable Sales                                   |                                   |  | \$ 1,283,926                                     |
| Gross Profit   |                                   |  | \$ 406,701                                       |
| Markup (\$406,701 ÷ \$1,283,926)                                 |                                   |  | 31.68%   |

① All markups have been adjusted for any markons or markdowns.

② Markup on total nongrocery taxables has been computed in the normal manner.

③ Supporting shelf test of markup computation illustrated herein, others not shown.

**SHELF TEST ON BEER**

Test Period: April 1978

| DATE   | INVOICE<br>NUMBER | VENDOR                           | COST        | RETAIL<br>EXTAX |
|--------|-------------------|----------------------------------|-------------|-----------------|
| 4-2-78 | 629452            | Lane Distributing Co.            | \$ 559.64   | \$ 737.20       |
| 4-2-78 | 39819             | National Brewers                 | 222.72      | 297.20          |
| 4-4-78 | 45293B            | City Distributors                | 553.78      | 737.52          |
| 4-7-78 | 098757            | Smythe Brewing Co.               | 475.66      | 620.11          |
| 4-7-78 | 75923             | Bunkers Brewers Inc.             | 173.10      | 237.79          |
|        |                   |                                  |             |                 |
|        |                   | Total                            | \$ 6,466.38 | \$ 8,540.54     |
|        |                   | Cost                             |             | \$ 6,466.38     |
|        |                   | Gross Profit                     |             | \$ 2,074.16     |
|        |                   | Markup (\$2,074.16 ÷ \$6,466.38) |             | 32.08%          |



## Exhibit 7

Test Period: April 1978

Test Period: April 1978

*Additional information on the cost plus markup method is included in Regulation 1602.5*